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No. 170

In the Supreme Court of the United States

October Term, 1935

German Evans Corporation, Petitioner

v.

Max Eastwood, Secretary and Engineer Commissioner, Chesapeake Conservation and Water Claimants

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS AND CROSS-PETITIONER

[illegible]
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In the Supreme Court of the United States

OCTOBER TERM 1955

No. 170

GENERAL STORES CORPORATION, PETITIONER

v.

MAX SHLENSKY, SECURITIES AND EXCHANGE COMMISSION, CREDITORS' COMMITTEE AND WAGE CLAIMANTS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the District Court (R. 6a–11a) is reported at 129 F. Supp. 801. The majority and dissenting opinions in the Court of Appeals (R. 86a–92a) are reported at 222 F. 2d 231.

JURISDICTION

The judgment of the Court of Appeals was entered on April 14, 1955 (R. 93a). The petition for a writ of certiorari was filed on June 22,

1955, and was granted on October 10, 1955 (R. 93a). The jurisdiction of this Court rests upon 28 U. S. C. 1254 (1).

QUESTION PRESENTED

Whether a corporate debtor with assets of about $5,000,000, approximately 7,000 stockholders, and over 2,000,000 shares of common stock actively traded on a national securities exchange, may utilize the arrangement procedure of Chapter XI of the Bankruptcy Act or whether it must use the corporate reorganization procedure of Chapter X.

STATUTE INVOLVED

Chapters X and XI of the Bankruptcy Act, 52 Stat. 883 and 905, 66 Stat. 431 (11 U. S. C. 501 *et seq.* and 701 *et seq.*) are involved in this proceeding substantially in their entirety. The provisions of Sections 328 and 366, which are directly involved, are set forth at pages 49 and 50 of petitioner's brief. A comparative summary of the pertinent provisions of both chapters is set forth in Appendix A, *infra* pp. 49–51.

STATEMENT

The petitioner, General Stores Corporation, which instituted this proceeding as a petitioning debtor under Chapter XI of the Bankruptcy Act, is a New York corporation organized in 1915. Petitioner was formerly known as D. A. Schulte, Inc.; it assumed its present name in 1954 (R. 7a,

12a, 31a). From its inception, and until recently, it was engaged in the business of operating chain stores for the sale of tobacco and accessory products, principally in the northeastern states (R. 7a).

The debtor has outstanding 2,232,422 shares of $1 par value common stock, which is listed and actively traded on the American Stock Exchange. This stock is held by over 7,000 widely scattered shareholders. (R. 7a, 30a.)

In the schedules attached to its petition petitioner listed assets, per books, of $4,921,421; of which about $4,000,000 represented investments in the stocks of Stineway Drug Company and Ford Hopkins Company—two wholly-owned subsidiaries—which stocks petitioner recently acquired under circumstances and upon terms hereinafter described (R. 34a). Its liabilities were listed at $3,900,410, which included secured notes in the amount of $2,065,000 and unsecured notes for $1,310,000. See pp. 6–7, *infra*. Its obligations to trade creditors amounted to $524,970. (R. 35a, 41a.)

Petitioner's financial difficulties are not of recent origin. They relate back at least to 1936 when it filed a petition for reorganization under former Section 77B of the Bankruptcy Act. It emerged from reorganization in 1940. (R. 7a, 21a, 30a.) Petitioner enjoyed a few profitable years during the war boom. Then a post-war

decline in volume and prices, coupled with rising costs, resulted in substantial losses, and, as the district court observed, "[a]ttempts at modernization of existing units failed materially to stem continuing losses." (R. 7a.) During the four years and five months ended March 31, 1953, the debtor sustained aggregate losses exceeding $2,700,000. In the next twelve months aggregate losses continued to increase and reached over $4,200,000. (R. 32a.)

In the post-war years, a substantial amount of equity capital was raised by the sale of additional common stock. In July 1951, nine investors purchased 400,000 shares of stock at $1.50 per share, or at a total price of $600,000. These purchasers also received options to purchase 332,157 additional shares, one-half of this amount at $1.60 per share and the balance at $1.70 per share. (R. 30a.) Following these transactions, a new management was installed with the intention of using the new money for converting existing stores into candy or food and drink establishments. When further study indicated that conversion would be too costly, the program was abandoned and the proceeds of the stock sale were used for general corporate purposes. (R. 8a, 31a, 32a.)

In 1952, at the insistence of the option holders, virtually all of the shares subject to the 1951 transactions were registered with the Securities

and Exchange Commission under the Securities Act of 1933 for the purpose of enabling these holders to make a secondary offering of the stock to the public. As of July 21, 1954, 404,769 of these shares were thus sold. (R. 31a.) In 1954, an additional 178,500 shares were sold by petitioner at $1.375 per share, and the proceeds, in the amount of $245,438, were applied to the purchase of the stock of Ford Hopkins Company, as further shown below. (R. 9a, 31a.)

Having concluded that conversion and modernization of its facilities were not feasible, the management turned to other alternatives for profitable operations. It was decided to liquidate the existing specialty stores and to have the debtor become a holding company by acquiring all the outstanding stocks of Stineway Drug Company and Ford Hopkins Company. The Stineway stock was acquired in August 1953, the Ford Hopkins stock early in 1954. (R. 8a–9a.) Stineway operates a chain of 23 retail drug stores in the Chicago area; it also sells merchandise to 12 independent stores in that area known as the Stineway System Stores. Ford Hopkins operates a chain of 48 drug stores and three restaurants in the Midwest. A subsidiary of Ford Hopkins, Sargent's Drug Store, operates five stores in the Chicago area and supplies standard cosmetic items to about 700 grocery chain stores. (R. 8a, 9a, 32a, 33a.)

The Stineway stock was acquired at a cost of $1,220,320, for the payment of which petitioner ultimately borrowed from Stineway $870,000. As of the date when the Chapter XI petition here involved was filed, petitioner was indebted to Stineway in the amount of $1,310,000, the balance of $440,000 representing an additional loan to help make the down payment on the purchase by petitioner of the Ford Hopkins stock. (R. 8a, 32a.) This total indebtedness to Stineway was represented by two non-interest bearing notes, one for $225,000 payable December 15, 1954, and the other for $1,085,000 payable June 1, 1964 (R. 33a–34a). None of these loans has been paid to date. It may be noted that, exclusive of the latter note, the debtor has estimated the Stineway net worth at $500,000 (R. 34a). The $1,310,000 in loans to the debtor thus appears to represent a major portion of Stineway's net worth.

The purchase price of the Ford Hopkins stock was $2,800,000, payable $735,000 upon consummation, the balance in minimum amounts of $200,000 per year, at 4% interest (R. 9a, 48a). The down payment of $735,000 was derived from (1) the proceeds of the sale of 178,500 shares of common stock in May 1954: $245,438; (2) the proceeds of loans, including one from the debtor's president: $55,000; and (3) the proceeds of a loan from Stineway: $440,000. Stineway derived this cash from the sale of warehouse inventory to Ford

Hopkins, which in turn was required to borrow $400,000 from a bank in order to pay for the inventory. (R. 9a, 33a.)

To secure the balance of the purchase price, $2,065,000, the debtor transferred the following collateral to a trustee: (1) all of the capital stock of Ford Hopkins and Stineway; (2) dividends payable upon Ford Hopkins and Stineway stock; (3) life insurance policies aggregating $1,700,000 upon the life of the trustee (one of the sellers); and (4) petitioner's rights to commissions payable to it by Ford Hopkins and Stineway under service contracts based generally upon 1% of the net sales of Ford Hopkins and Stineway (R. 9a; 33a).

To complete the process of conversion, petitioner commenced to liquidate its own stores (R. 8a). Although it was operating 146 of such stores on July 21, 1954, there remained only 76 at the time petitioner filed its petition for relief under Chapter XI of the Bankruptcy Act on October 18, 1954 (R. 32a, 42a). During the Chapter XI proceeding, it disposed of all its remaining stores. These dispositions were facilitated through court-approved rejection of leases pursuant to Section 313 (1) of Chapter XI, and as a consequence have created landlords' claims under Section 353 of that Chapter. (R. 45a.)

In its petition under Chapter XI, filed on October 18, 1954, a few months after the acquisition

of the Ford Hopkins stock, petitioner proposed an arrangement extending its unsecured obligations and providing for payment of 20% on confirmation and 20% annually for four years thereafter (R. 12a–14a). The notice to creditors listed, besides the obligation to Steinway, unsecured claims of about $525,000 (R. 41a). This is exclusive of landlords' claims resulting from the subsequent rejection of leases in the course of the Chapter XI proceedings.

The District Court granted the motions of the Commission and of a stockholder to dismiss the Chapter XI proceeding unless the petitions were amended to comply with the requirements of a petition under Chapter X (R. 3a–11a). The Court of Appeals, with District Judge Galston dissenting, affirmed (R. 86a–93a).

SUMMARY OF ARGUMENT

1. This case is controlled by *Securities and Exchange Commission* v. *United States Realty & Improvement Company*, 310 U. S. 434, where a corporation with publicly held securities was not permitted to utilize the procedure for an arrangement under Chapter XI of the Bankruptcy Act because it was held that adequate relief could be obtained only through Chapter X of the Act. The "'relief * * * available under Chapter X" was determined to be "more consonant" with "considerations growing out of the public policy of the Act found both in its legislative history and

in an analysis of its terms." *Id.* at 448. As there pointed out, Chapter X was intended to provide the investing public with numerous protections against the evils and abuses that had pervaded earlier reorganizations, protections absent from Chapter XI and unnecessary for the "small * * * corporations with few stockholders" for which Chapter XI is adapted. *Id.* at 447.

As in the *Realty* case, the debtor here has public security holders entitled to the protections of Chapter X. Moreover, this debtor has a history of financial difficulties, has suffered large and mounting losses in recent years, and came to the bankruptcy court while it was only part way through a program attempting to recast its entire business. In these circumstances, only the thorough procedures of Chapter X are adequate for dealing effectively with the readjustment of all the financial affairs of the debtor, which operates through newly purchased subsidiaries a substantial business enterprise in a field new to it.

2. Petitioner's argument that it is the plan advanced by the debtor rather than the character of the debtor that controls is wholly contrary to the *Realty* decision, which repeatedly emphasized the type of debtor involved rather than the relief sought. This Court made clear that the "adequate relief" referred to in the Bankruptcy Act as a basis for choosing between Chapter X and Chapter XI is not synonymous with the relief

sought by the management and acceptable to trade creditors, as petitioner claims, but must be determined "in the light of its effect on all the public and private interests concerned. * * *" *Id.* at 455. Moreover, the determination as to the comparative adequacy of the relief afforded by the two chapters is to be made at the outset of the proceeding. Under Chapter X, however, there could be no plan in existence at that time, so that the comparison cannot be made upon the basis of specific plans. This fact demonstrates sharply the fallacy of the argument that the nature of the plan proposed should be decisive in choosing between Chapter X and Chapter XI.

3. The 1952 amendments to the Bankruptcy Act reveal Congressional adoption of the rule in the *Realty* case and acceptance of the proposition that Chapter XI is not to be used for corporations with numerous investors. The removal of the "fair and equitable" requirement for a Chapter XI plan, upon which petitioner relies, is shown by the legislative history to have been intended only for individual debtors or corporations "where the stock ownership is substantially identical with management." Simultaneously, Congress enacted a provision setting up machinery for dismissal of a proceeding improperly brought under Chapter XI or its transfer to Chapter X and authorizing the Securities and Exchange Commission to apply for such relief. The legis-

lative history states that this provision "codifies the law" of the *Realty* case. Moreover, the 1952 amendments were considered "noncontroversial in character" and clearly could not have intended the far-reaching results for which petitioner contends.

4. The fact that the public investors with whom the Court was concerned in the *Realty* case were creditors rather than stockholders constitutes no basis for distinction. The numerous protections for public investors in Chapter X are specifically made available to "stockholders" as well as to "creditors." Petitioner contends that, by reason of the removal of the "fair and equitable" provision from Chapter XI, stockholders may conceivably enjoy benefits *vis-à-vis* creditors in Chapter XI which are unavailable in Chapter X. But Congress could not have intended this result to depend upon the management's choice of the statutory reorganization technique to be followed. And Congress was evidently satisfied that the significant benefits provided by Chapter X for the numerous investors of corporations like the U. S. Realty Co. and the debtor in this case would outweigh any possible benefits they might derive from Chapter XI.

Thus, even assuming that in a particular Chapter XI proceeding trade creditors might agree to take less than the amount of their claims in order to have the debtor continue in business, such con-

finance in business might not be in the interests of the debtor's stockholders since it could lead to the dissipation of an existing equity for stockholders. Under Chapter XI public stockholders would have the advice only of the debtor's management, rather than the benefit of advice of an independent trustee based upon an objective investigation as to whether the business should be continued and the nature of any reorganization required. Nor would they under Chapter XI have the benefit of possible causes of action against existing or former management which an independent trustee might uncover. Moreover, under Chapter X, in appropriate circumstances, individual trade creditors could agree to take less than the full amount on their claims, since the considerations affecting the absolute priority rule (required by the "fair and equitable" standard) might be different with respect to such creditors from those involving public holders of debt obligations.

ARGUMENT

THE COURTS BELOW PROPERLY HELD THAT THE DEBTOR, A SIZABLE CORPORATION, OPERATING THROUGH SUBSIDIARIES AND HAVING NUMEROUS PUBLIC STOCKHOLDERS, MAY NOT UTILIZE THE ARRANGEMENT PROCEDURE OF CHAPTER XI OF THE BANKRUPTCY ACT IN AN ATTEMPT TO RELIEVE ITS SERIOUS BASIC DIFFICULTIES, BUT MAY USE ONLY CHAPTER X, WHICH PERMITS A THOROUGH REORGANIZATION AND CONTAINS SAFEGUARDS FOR PUBLIC INVESTORS

Following the guideposts furnished by this Court in *Securities and Exchange Commission* v. *United States Realty & Improvement Company*, 310 U. S. 434, the courts below have held that the petitioner may not utilize Chapter XI of the Bankruptcy Act, but that the "widespread stockholder interest in a corporation with such a shaky financial history as this one" (R. 88a) requires any rehabilitation under the Bankruptcy Act to be conducted solely through Chapter X, which contains appropriate safeguards for public investors. Petitioner first attempts to distinguish this case from the *Realty* case. Alternatively, it seeks reversal of the courts below on the basis of certain amendments to Chapter XI made in 1952, which petitioner reads as overruling the *Realty* case or greatly limiting its application. We shall show that the courts below properly applied the principles of the *Realty* decision and that petitioner's arguments to the contrary are in large part the

very arguments which were there rejected by this Court. We shall also show that the 1952 legislation neither overruled, nor limited *U. S. Realty*; but was premised on full acceptance of that decision.

I. THE CONSIDERATIONS WHICH WERE CONTROLLING IN THE *REALTY* CASE ARE EQUALLY CONTROLLING HERE

In the *Realty* case this Court reversed the determination of two lower courts that an arrangement under Chapter XI of the Bankruptcy Act might be utilized by the corporation there involved, which, like the debtor here, had numerous public investors. The debtor in that case had outstanding 900,000 shares of stock listed on the New York Stock Exchange and held by some 7,000 stockholders. It had assets of a stated value of approximately $7,000,000. It had direct liabilities of about $5,000,000, approximately half of which consisted of two series of publicly-held secured debentures; and it was a guarantor of defaulted sinking fund certificates issued by a wholly-owned subsidiary in the amount of approximately $3,700,000 and held by some 900 persons. The plan of arrangement contemplated a modification of the terms of the guarantee. This Court pointed out that the question whether Chapter X or XI was available turned "on considerations growing out of the public policy of the Act found both in its legislative history and in an

analysis of its terms", and hold it to be reversible error for a proceeding to be entertained under Chapter XI "when relief is available under Chapter X, which is adequate and more consonant with that policy" (310 U. S. at 448).

Equity receiverships, the Court pointed out, had been characterized by "lack of knowledge and control by the court of the conditions attending formulation of reorganization plans, the inadequate protection of widely scattered security holders, the frequent adoption of plans which favored management at the expense of other interests, and which afforded the corporation only temporary respite from financial collapse" (*id.* at 448). These conditions were intended to be eliminated in Chapter X, which operated on "the basic assumption * * * that the investing public dissociated from control or active participation in the management, needs impartial and expert administrative assistance in the ascertainment of facts, in the detection of fraud, and in the understanding of complex financial problems" (*id.* at 448–449, footnote 6).

The legislative history of the Chandler Act, by which Chapters X and XI came into existence, makes clear the wholly different rehabilitation problems presented by a corporation having publicly-held securities from those presented by an

individual or a closely held corporation.[1] The differences arise because public investors normally tend to be widely scattered and unable to attend meetings; their individual investments are often small and they may have little financial experience. Since they are not directly connected with the management of the enterprise, they may know comparatively little about it. By contrast, in a corporation without public investors the stockholders or persons closely allied to them normally constitute the management. Creditors are usually banks or trade creditors; they are familiar with the debtor's condition, management and prospects; they are able to act as a unit through trade and credit associations or through counsel or informal committees; and they may expect, moreover, to profit through future dealings with the debtor. It is for this latter sort of business that

[1] See, for example, the Report of a Special Senate Committee to Investigate Receivership and Bankruptcy Proceedings (S. Doc. No. 268, 74th Cong., 2d sess.), which stated (p. 13):

"There is * * * a clear distinction to be observed between a corporation the stock of which is privately owned by a small number of persons and which is indebted to trade creditors, and a corporation the securities of which are in the hands of the public. The problems of the former are not shared by the latter; the problems of the latter have no concern with the former."

Legislative and other materials detailing the problems are listed in the *Realty* case, 310 U. S. at 449, footnote 7.

Chapter XI was intended, since in such situations the safeguards of Chapter X may not be essential.

These safeguards were summarized in the *Realty* case as follows (310 U. S. at 449–450):

> Except where the liabilities are less than $250,000, Chapter X requires the appointment of a disinterested trustee, §§ 156–158, and a thorough examination and study by the trustee of the debtor's financial problems and management, § 167 (3) (5). The trustee is required to report the result of his study, to send the report to all security holders with notice to submit to him proposals for a plan of reorganization, § 167 (5) (6). He then formulates a plan or reports the reasons why a plan cannot be formulated, § 169. By § 176 consent to a plan in advance of its initial approval by

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[3] As pointed out in the *Realty* case, 310 U. S. at 447, Chapter XI was devised for "composition of debts of small individual business and corporations with few stockholders." It "was sponsored by the National Association of Credit Men and other groups of creditors' representatives expert in bankruptcy." *Id.* at 450, footnote 8. See, *e. g.*, the statement of a representative of the National Bankruptcy Conference at the hearing before the House Committee on the Judiciary (House Hearings on H. R. 6439, 75th Cong., 1st sess. (1937), p. 45):

"Subsection I [Chapter XI] is no different from the present section 12 which has been with us for year[s], except that it allows wider rights. A man goes in, who has a little business as a druggist, and wants to make a composition with his creditors."

The cases for which Chapter XI was intended were also referred to as "'hot-dog stand' cases." House Hearings on H. R. 6439, 75th Cong., 1st sess. (1937), p. 175.

the judge is void unless procured with his consent. A large measure of control is given to the court over the reorganization and of committees of security holders and their compensation, §§ 163, 165, 209, 212, 241–243.

If the judge finds the plan presented worthy of consideration he may refer it to the Commission for report and must do so where the liabilities of the debtor, as in the present case, exceed $3,000,000, § 172. When the plan is submitted to creditors after approval by the judge it is accompanied by the report of the Commission and the opinion of the judge approving the plan, § 175. The Commission with the approval of the court is authorized to participate generally in the proceedings as a party, and it is its duty to do so upon request of the court, § 208.

In contrast, this Court pointed out (*id.* at 450–451):

No comparable safeguards are found in Chapter XI. Every phase of the procedure bearing on the administration of the estate and the development of the arrangement is under the control of the debtor. The process of formulating an arrangement and the solicitation of consent of creditors, sacrifices to speed and economy every safeguard, in the interest of thoroughness and disinterestedness, provided in Chapter X. The debtor is generally permitted to stay in possession and operate the

> business under the supervision of the court, § 342, and a trustee is provided for only in the case where a trustee in bankruptcy has previously been appointed and is in possession, or if "necessary" a receiver may be appointed. § 332. The debtor proposes the arrangement, §§ 306 (1), 323, 357, and the only opportunity afforded the creditors in respect to the proposed plan is to accept or reject it as submitted by the debtor. * * *
>
> * * * The arrangement may be consummated at the conclusion of a single creditor's meeting. The court in passing upon the arrangement, is without the benefit of investigation and study by the trustee or Commission, which Congress has required in reorganization proceedings under Chapter X; and is then faced with the fact that a majority of the creditors have already accepted the plan.[3]

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[3] A detailed chart contrasting the provisions of Chapters X and XI is set forth in Appendix A to this brief, *infra*, pp. 49–51.

Similar provisions under both chapters exempt securities issued pursuant to a plan from the registration requirements of Section 5 of the Securities Act of 1933, 15 U. S. C. 77e. See Section 264a (2) under Chapter X and Section 393a (2) under Chapter XI. An effective substitute for such registration is provided under Chapter X by various of the provisions referred to in the *Realty* case, such as preliminary judicial approval of a plan, court control over the information to be disseminated, and the report of the Securities and Exchange Commission on the plan. The lack of comparable controls under Chapter XI is further evidence

We submit that the considerations set forth above, which were controlling in the *Realty* case, should be equally controlling here. As we have seen, the debtor's securities are widely held, and this fact alone would seem sufficient to require a determination that adequate relief is unattainable under Chapter XI. Moreover, the debtor is and has been for many years in serious basic difficulties. It has sustained mounting losses and is today unsoundly financed. Largely with borrowed monies, the proceeds of sale of additional stock to persons close to management (subsequently sold in part to the public), and the syphoning off of cash from purchased companies, the debtor has acquired ownership of two drug chains in a new area. Then, halfway through the program of converting its operations, the debtor found it necessary to invoke the jurisdiction of the bankruptcy court. These facts make it clear that Chapter XI is inappropriate and that the case calls for the more thorough and better safeguarded proceedings provided by Chapter X.

Petitioner seeks to avoid Chapter X, which would afford the bankruptcy court the broadest

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of the Congressional intent to limit the use of that Chapter to small, closely-held corporations, since there is no cogent reason why Congress could have intended that all such controls could be avoided by a corporation issuing such new securities to its public securities holders by the simple expedient of proceeding under Chapter XI.

powers to deal with its problems, even though petitioner, now operating wholly through subsidiaries, may well require an overall reorganization which would deal with the assets of the subsidiaries. Chapter XI contains no machinery to reach that result. As stated in the *Realty* case, 310 U. S. at 452, "a subsidiary of the debtor may be brought into * * * a [Chapter X] proceeding and reorganized with the debtor. § 129." Certainly, a debtor may not have part of its reorganization under Chapter XI and part outside the Act. This was what was proposed in the *Realty* case. To deal effectively with financing problems and the possibility of incompetent or bad management in this extensive corporate enterprise, Chapter X alone provides the necessary investigative and analytical procedures, the necessary powers in the court to effectuate a sound result, and the necessary protections for the interest of the debtor's public investors in the substantial book equity represented by the debtor's assets which are pledged for the debtor's collateral notes. Under these circumstances, as this Court held in the *Realty* case, it would have been contrary to the policy of the Chandler Act for the courts below to have permitted Chapter XI to be utilized by the debtor.

2. PETITIONER ERRS IN ARGUING THAT IT IS THE PLAN RATHER THAN THE CHARACTER OF THE DEBTOR WHICH IS CONTROLLING

In urging that the *Realty* case is not controlling here, the petitioner argues (Br. 11) that the

"essential characteristic of the debtor's petition in this case, as distinguished from the petition in the *U. S. Realty* case is the proposed plan." It assumes that it was the plan involved in the *Realty* case and "not the character of the debtor" which there precluded the use of Chapter XI (Pet. Br. 39).

The essential fallacy in this argument arises from petitioner's interpretation of the meaning of "adequate relief" as used in Sections 130 (7) and 146 and 147 of the Act (see Pet. Br. 16–18, 23–28). This key phrase does not mean, as the petitioner seems to think, merely the steps which the debtor's management desires and which are acceptable to the merchandise and other creditors who would participate in a Chapter XI proceeding. As this Court made clear in the *Realty* case (310 U. S. at 447–448):

> * * * granting the jurisdiction of the court [under Chapter XI], the question remains of the propriety, in the circumstances, of its order retaining jurisdiction, and of the extent of its duty to go forward with the proceeding under Chapter XI in the face of the contention that Chapter X alone affords a remedy adequately protecting the public and private interests involved. The answer turns not on the court's statutory jurisdiction to entertain a proceeding under Chapter XI, but on considerations

> growing out of the public policy of the Act found both in its legislative history and in an analysis of its terms, and of the authority of the court clothed with equity powers and sitting in bankruptcy to give effect to that policy through its power to withhold relief under Chapter XI when relief is available under Chapter X, which is adequate and more consonant with that policy.

Again, this Court stated that "the adequacy of the relief under Chapter XI must be appraised in comparison with that to be had under Chapter X, and in the light of its effect on all the public and private interests concerned including those of the debtor." *Id.* at 455.

All interests must be appraised. For that reason, use of Chapter XI is not rendered proper, as petitioner believes (see Pet. Br. 17, 24–27), by the fact that the commercial creditors here involved may have adequate representation and may not need a report of this Commission. For the debtor's public investors are necessarily concerned when the financial affairs of their corporation have so deteriorated that resort to the rehabilitation provisions of the Bankruptcy Act is necessary. And, as we have seen, pp. 15–18, *supra*, the interests of these public investors require all the procedures of Chapter X. See also, *infra*, pp. 37–46.

Petitioner urges that Chapter XI is not wholly devoid of protective provisions, pointing out that there can be an examination pursuant to Section 21 of the Bankruptcy Act or the appointment of a receiver[4] (Br. 27–28). The *Realty* case shows, however, that these are not adequate substitutes for the full protections afforded public investors by Chapter X, *supra*, pp. 17–19. As this Court stressed in that case, Chapter X was designed by the Congress to assure to public investors the safeguards and protections it determined to be necessary to achieving the satisfactory rehabilitation of a corporation in financial difficulties. It would be

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[4] Section 332 of the Act gives the court power to appoint a receiver "if necessary." See Rostow and Cutler, *Competing Systems of Corporate Reorganization*, 48 Yale Law Journal 1334, 1341 (1939) (footnotes omitted):

"The appointment of a custodian is discouraged. It is provided that upon the application of a party in interest the court may appoint a receiver, if necessary. Presumably the applicant will have to show grounds of necessity comparable to those required under Section 2a (3), governing the appointment of bankruptcy receivers generally. It is significant that Chapter XI, drafted by bankruptcy lawyers, provides for a receiver and not a trustee, for a receiver under the Bankruptcy Act has been an officer of limited authority, with less capacity for initiative than a trustee. The receiver may carry on the business and issue certificates of indebtedness, but he has no functions of inquiry, nor any duties in connection with drafting the arrangement. It is unlikely that receivers under Chapter XI will be appointed as often as trustees under Chapter X. And even where a receiver is appointed, the Act makes no provision for an investigation, a report, or a determination of the economic justification for continuing the business."

anomalous, indeed, if a corporation like the petitioner could escape these legislative safeguards and protective measures by merely proposing a plan limited to an arrangement. One of the reforms accomplished by Chapter X was the adoption of Section 169 of the Act, which provides that the independent trustee rather than the debtor is responsible for the initial submission of a plan. The debtor cannot dictate the form or substance of a Chapter X reorganization, whether commenced voluntarily or involuntarily. It would be wholly inconsistent with the purpose of this reform if by reason of the relief it requests a debtor could choose between Chapter XI and Chapter X. *Cf. Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, 129 *et seq.*

That it was the character of the debtor rather than the plan proposed which was determinative of the *Realty* decision is also clear from additional portions of the opinion. References to Chapter X as "adapted to the reorganization of corporations with complicated debt structures and many stockholders" and to Chapter XI as adapted "to composition of debts of small individual business and corporations with few stockholders" (310 U. S. at 447) are wholly contrary to petitioner's view. So also is the observation that denying the propriety of Chapter XI for corporations like the U. S. Realty Co. and the present petitioner left room "for application of that chapter in many

cases where the debtor's financial business and corporate structure differ from respondent's", as in the case of "small individual or corporate business" (310 U. S. at 454).

The conclusion that it is the character of the debtor which is decisive in choosing between Chapter X and Chapter XI derives further support from the fact that the court must determine at the outset of the proceeding which of the two chapters is applicable. In the *Realty* case, it was pointed out (p. 455) that had the debtor proceeded under Chapter X, "the judge would have been compelled upon inquiry to approve its petition on the ground * * * that adequate relief could not be obtained under Chapter XI." That determination would have had to be made without reference to any plan or arrangement, and would necessarily have rested on the character and financial situation of the particular corporation involved.[5] The *Realty* case held that the same approach had to be used where the issue arose in a Chapter XI proceeding.

Reference in the *Realty* opinion to the arrangement actually proposed in the Chapter XI pro-

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[5] The provisions respecting formulation of a plan are contained in Article VII of Chapter X, headed "Proceedings Subsequent to Approval of Petition." See Sections 168–170. The plan is prepared by the trustee (Section 169), who is not appointed until "the approval of a petition" (Section 156). Cf. *In re Julius Roehrs Co.*, 115 F. 2d 723 (C. A. 3).

ceeding, as well as to possible amendments thereto (*id.* at 453), were merely to illustrate the need for the protections for public investors afforded by Chapter X. As a matter of fact, neither in that case nor in the instant case did the plan which was proposed purport to be immutable; indeed, as petitioner states (Br. 4)[6]: "Arrangement plans may be (and they usually are) altered or modified at various stages of a proceeding up to the time of confirmation."

Recognition of this fact is hardly consistent with petitioner's insistence that the initial, admittedly tentative, proposal of the debtor should control the selection of the appropriate chapter. Rather, it reinforces the view that the nature of the debtor, the financial difficulties of which occasion the resort to the Bankruptcy Act, must be determinative.

The facts stressed by petitioner—that it comes within the express definition of a "debtor" in Sections 4 and 306 (3) of the Act and that it has submitted an "arrangement" within the definition of Section 306 (1) (Pet. Br. 17, 38)—were equally present in the *Realty* case, where this Court conceded that the requirements of these sections were met, stating (310 U. S. at 446):

> It is evident that the language of the sections to which we have referred in terms

[6] The *Realty* case refers to "an amended arrangement which is not in the record and the terms of which are not disclosed." 310 U. S. at 453.

> confers on the court jurisdiction of a petition for an arrangement, which the present petition is, filed by a debtor, which the respondent is, in the technical sense that it confers on the court power to make orders in the cause which are not open to collateral attack.

Only the minority of the Court considered this controlling. In quoting statements to that effect from the dissenting opinion (Pet. Br. 35, 40, 41), petitioner appears to be urging this Court to overrule the *Realty* decision. We submit that the considerations requiring the result reached in that case are fully applicable today, and, as pointed out below, that this has been recognized by Congress.

3. THE 1952 AMENDMENTS TO THE BANKRUPTCY ACT ACCEPTED AND CODIFIED THE *REALTY* HOLDING; THEY DID NOT OVERRULE IT OR LIMIT ITS APPLICABILITY

The only changed circumstance to which petitioner points in urging that this Court reverse itself is the 1952 amendatory legislation to the Bankruptcy Act.[7] This legislation, however, as Judge Clark pointed out in the opinion below, wrote into the Bankruptcy Act the "criteria for choice between Chapter XI and Chapter X enunciated" in the *Realty* case (R. 89).

Far from suggesting that the rule of the *Realty* decision was to be changed, the Congress which

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[7] 66 Stat. 420.

wrote the 1952 amendments expressly stated its purpose to codify that rule. Thus, the Report of the House Committee states:[8]

> Section 30 of the bill adds a new section 328 at the end of article IV of chapter XI of the act. In *Securities and Exchange Commission* v. *U. S. Realty & Improvement Co.*, 310 U. S. 434, 42 Am B. R. (N. S.) 602, 60 S. Ct. 1044; 84 L. Ed. 1293 (1940), where a petition was filed under chapter XI by a debtor corporation having hundreds of creditors and thousands of stockholders, it was decided that the court had the duty to dismiss the petition, leaving the corporate debtor to seek relief under chapter X. In that case, the petition under chapter XI was dismissed after the proceeding had been running for many months and a proceeding had to be started anew under chapter X.
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> Under section 147 of chapter X, a petition improperly filed thereunder, because adequate relief can be obtained by the debtor under chapter XI, may be transferred to chapter XI and thereafter for the purposes of chapter XI, be deemed to have been originally filed thereunder. There is no corresponding provision in chapter XI for a transfer of a chapter XI proceeding, if improperly filed thereunder, to chapter X. The proposed amendment supplies this lack. *It codifies the law of the United*

[8] H. Rep. No. 2320, 82d Cong., 2d sess, p. 19.

> *States Realty & Improvement case, and adopts the procedure of section 147 for transferring the proceeding to chapter X.* [Emphasis added.]

It is clear that this intended codification was not, as petitioner suggests (Br. 15, 39–40), designed merely to give the courts explicit procedural power to dismiss an improper Chapter XI petition or order its transfer to Chapter X. For whatever might be the significance of the new Section 328 standing alone, other aspects of the 1952 amendments leave no room for doubt that Congress accepted and carried forward the substantive principles of the *Realty* case. Thus, although petitioner relies (Br. 13, 22, 35–36) upon the amendment which deleted the requirement that an arrangement under Chapter XI must be "fair and equitable,"[9] the explanation accompanying

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[9] 66 Stat. 433.

The "fair and equitable" requirement, which is contained in Chapter X (Sections 174 and 221 (2) of the Act), was derived from the predecessor statute, Section 77B, and in turn from equity receivership precedents. This Court has held that the requirement embodies the doctrine of absolute priorities, under which a reorganization plan must fully compensate creditors and stockholders in the order of their priorities; that is, seniors must receive the equitable equivalent of the full value of their claims before juniors may participate, and if senior claimants are not compensated in full, juniors may receive nothing unless they make a fresh contribution of capital. *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, 115–119; *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510, 527–529.

this change shows (1) that it was in no sense fashioned for the alteration of the *Realty* rule petitioner seeks, but (2) that it was premised squarely on the assumption that this rule remained desirable and unimpaired. Proceeding on this premise—that the scope of Chapter XI was to remain as limited in the *Realty* case—the House Report stated:[10]

> * * * the fair and equitable rule, as interpreted in *Northern Pacific Railway Co.* v. *Boyd*, 228 U. S. 428, 33 S. Ct. 554, 57 L. Ed. 931 (1913), and *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, 41 Am. B. R. (N. S.) 110, 60 S. Ct. 1, 84 L. Ed. 110 (1939), cannot realistically be applied in a chapter XI * * * proceeding. Where it is so applied, no individual debtor, and under chapter XI, no corporate debtor *where the stock ownership is substantially identical with management could effectuate* an arrangement except by payment of the claims of all creditors in full. [Emphasis added.]

As the Report shows, it was the intent of the Congress to enable closely-held corporations, where there is substantial identity between stock ownership and management, to effectuate an arrangement without meeting the fair and equitable test. And this is, of course, perfectly consistent with

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[10] H. Rep. No. 2320, 82d Cong., 2d sess., p. 21. See also S. Rep. No. 1395, 82d Cong., 2d sess., p. 12.

the view expressed in the *Realty* case that Chapter XI has its appropriate application to (p. 454)

> * * * small individual or corporate business where there are no public or private interests involved requiring protection by the procedure and remedies afforded by Chapter X. In cases where subordinate creditors or the stockholders are the managers of its business, the preservation of going-concern value through their continued management of the business may compensate for reduction of the claims of the prior creditors without alteration of the management's interests, which would otherwise be required by the Boyd case.[11]

It is thus clear that Congress was content to remove the "fair and equitable" test from Chapter XI because it recognized and accepted the rule that cases where there are public investors are excluded from this Chapter.

It is to be noted, moreover, that the 1952 amendments were designed to be "uncontroversial in character" and were described in the House Report as "clarifying and perfecting changes."[12] But acceptance of petitioner's theory

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[11] The discussion in the *Realty* case of the "fair and equitable" provision formerly in Chapter XI merely buttressed the result reached by the Court upon the fundamental considerations we have previously reviewed.

[12] H. Rep. No. 2320, 82d Cong., 2d sess., pp. 2, 3. See also S. Rep. No. 1395, 82d Cong., 2d sess., p. 20, where in a letter from the Administrative Office of the United States Courts the proposals were referred to as "noncontroversial in character."

that the *Realty* decision was swept aside would mean Congress effected the major and certainly controversial result of permitting a debtor with publicly-held debentures to propose a plan of arrangement under Chapter XI, depriving the debenture holders of their right to absolute priority. An amendment of such grave and far-reaching effect can hardly be read either in the statutory changes Congress made or the explanations it gave in 1952. It may be noted that petitioner's contrary view as to the effect of deleting the "fair and equitable" requirement from Chapter XI received no acceptance by the dissenting judge below or by the different panel of the court below which decided that Chapter XI was proper for the debtor in *In re Transvision Inc.*, 217 F. 2d 243, certiorari denied, 348 U. S. 952.[13] Nor have the sponsors of the amendment suggested that it has had this result.[14]

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[13] We should state explicitly our view—with which compare the concurring opinion of Judge Frank (R. 90a) and the dissent of Judge Galston (R. 90a–91a)—that the decision below in the instant case is inconsistent with the principles followed in *Transvision*. For the reasons stated in this brief and in our petition for certiorari in *Transvision*, we think that case was incorrectly decided.

[14] The General Counsel for the National Association of Credit Men in a discussion of the 1952 amendments stated with respect to Chapter XI:

"Complementing the more cumbersome and costly procedure required by Chapter X, it provides a means for readjustment of the debt structure of enterprises large or small which are not affected by a public interest." Mont-

The pertinent materials all serve to refute petitioner's conclusion that the Commission has failed "over the past seventeen years to obtain recognition of its position from the Congress" (Pet. Br. 41). The statement is answered, not only by the 1952 amendments just reviewed, but also by earlier events which reflect Congressional understanding of the type of problem presented here and in the *Realty* case and approval of the Commission position there vindicated by this Court. While the *Realty* case was in the courts, a bill was pending in Congress which would have excluded from the definition of debtor in Section 306 (3) (Chapter XI) of the Act "a corporation if any class of securities of such corporation is owned by one hundred or more persons." Securities were therein defined to include both creditor and stock interests.[15] The bill also contained provisions relating to the basis of property for income tax purposes when a proceeding under Chapter X, XI or XII results in a cancellation or reduction of indebtedness. The House Committee found that prompt enactment of the income tax feature of the bill was necessary. However, it struck the above

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gomery, *Chapter XI and Recent Amendments*, 58 Commercial Law Journal 11, 14 (1953).

The National Association of Credit Men is a component of the National Bankruptcy Conference, which made the recommendations reflected in the 1952 amendments. See S. Rep. No. 1395, 82d Cong., 2d sess., p. 2.

[15] H. Rep. No. 2372, 76th Cong., 3d sess., pp. 5–6.

quoted provision which would have re-defined a debtor in a Chapter XI proceeding, because, although agreeing that the provision was "desirable," it found that "the element of emergency requiring * * * immediate passage has been eliminated by the decision of the United States Supreme Court in *Securities and Exchange Commission* v. *U. S. Realty & Improvement Company*."[16]

This Commission felt that there was no further need for legislation. It stated in its report to

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[16] *Id*, at p. 2. The Committee Report's full statement in this regard is as follows:

"Sections 4, 5, 6, and 7 of the bill, which are eliminated by the last of your committee's amendments, provided for amendments to chapter XI of the Bankruptcy Act which were designed to prevent corporations which are publicly indebted or owned from filing a petition for an arrangement under chapter XI, rather than a petition for reorganization under chapter X, the chapter specially designed for the reorganization of such corporations, and to establish a numerical test of such "public" indebtedness or ownership.

"Your committee believes that, while the amendments proposed by sections 4, 5, 6, and 7 are desirable, the element of emergency requiring their immediate passage has been eliminated by the decision of the United States Supreme Court in *Securities and Exchange Commission* v. *U. S. Realty and Improvement Company*. That decision was rendered on May 27, 1940, after the introduction of the bill. Since immediate action on these proposals does not appear to be necessary, the first of your committee's amendments provides for the striking out of sections 4, 5, 6, and 7. The committee's conclusion is supported by all of the witnesses who testified at the hearings before the committee's Subcommittee on Bankruptcy and Reorganization and also by the report of the Securities and Exchange Commission on the bill."

Congress with reference to the Court's decision in the *Realty* case:

> It appears, therefore, to be finally settled that resort to the provisions of Chapter XI is not appropriate in the reorganization of corporations with securities distributed in the hands of the public.[17]

Thereafter, until the decision in *In re Transvision,* 119 F. Supp. 134 (S. D. N. Y., 1953), affirmed, 217 F. 2d 243 (C. A. 2, 1954), certiorari denied, 348 U. S. 952, we believe there have been no cases where debtors with public investors utilized Chapter XI over the objection of this Commission.[18]

Subsequent to the *Transvision* decision, a motion of the Commission to dismiss the Chapter XI proceeding or transfer it to Chapter X was denied in *In re Wilcox-Gay Corporation,* 133 F. Supp. 548 (W. D. Mich., 1955), appeal pending. A similar decision was rendered in *In re Liberty Baking Company* (S. D. N. Y. No. 91173) on December 19, 1955 (printed in Appendix B).

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[17] Sixth Annual Report of the Securities and Exchange Commission (1941), p. 57.

[18] Reorganization proceedings where Chapter XI was attempted to be utilized until objection was made by the Commission include *In re Chancellor Hall* (E. D. Pa., No. 22213) (1943); *In re Solar Manufacturing Company* (S. D. N. Y., No. 85855) (1948); *In re American Silver Corporation* (S. D. Cal., No. 45,818–B) (1948); *In re Universal Camera Corporation* (S. D. N. Y., No. 88601) (1952); *In re Tele-Tone Corporation* (S. D. N. Y., No. 88448) (1952); *In re Lowell Adams Factors Corporation* (S. D. N. Y., No. 89575) (1953).

The corporations involved in these two cases had both publicly held debentures and stock and in the latter case the arrangement proposed to alter the rights of debenture holders.

4. THE FACT THAT THE PUBLIC INVESTORS HERE ARE STOCKHOLDERS RATHER THAN CREDITORS CONSTITUTES NO REASON FOR DISTINGUISHING THE *REALTY* CASE

Petitioner seeks to distinguish this case from the *Realty* case on the ground that here the only public investors are stockholders (Br. 14, 19, 28–31). But petitioner's own observation (Br. 20) that neither stockholders nor this Commission on their behalf has any status under Chapter XI except to raise the question whether the debtor should properly be under Chapter X (Br. 20) serves to emphasize the need in a case like this for application of Chapter X, where the numerous protections for public investors are specifically made available to stockholders as well as to creditors.[19] Petitioner argues in this connection (Br.

[19] There is specific provision, for example, in Chapter X for notice to stockholders of the hearing for "objections to the continuance of the debtor in possession, or to the retention in office of a trustee upon the ground that he is not qualified or not disinterested * * *." Sections 161, 162. The trustee's statement as to "his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof" must be sent to stockholders. Section 167 (5). Stockholders may submit suggestions for the formulation of a plan and are to be given notice of this opportunity by the trustee as well as notice of all hearings on plans. Sections 167 (6) and 169–171. When a plan is approved, stockholders have for their consideration in determining whether to accept it the plan itself and all other approved plans "together with

20, 33) that neither the Commission nor stockholders may intervene where an adjudication in bankruptcy is sought, apparently to prove that they may not intervene in Chapter XI where the public interest is in the stock. But this ignores both the *Realty* holding and the specific provisions of Section 328. More significantly, it fails to recognize that most of the problems involved in reorganization are not involved in bankruptcy.[20]

In its effort to show that the result in the *Realty* case is inapplicable where the public in-

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a summary thereof approved by the judge," the judge's opinion of approval if any or an approved summary thereof, "the report, if any, filed * * * by the Securities and Exchange Commission * * * or a summary thereof prepared by the Securities and Exchange Commission", and "such other matters as the judge may deem necessary or desirable for the information of creditors". Sections 174–175. If the debtor has not been found to be insolvent the vote of a majority of each class of stock affected by the plan is normally required before a hearing is held on confirmation and the hearing must be on notice to stockholders. Section 179.

[20] "Reorganization involves all the problems of corporate finance and management: it requires an inquiry into the causes of the financial collapse of the corporation; and its worth if salvaged as a going concern; and, if reorganization instead of liquidation is determined upon, how this can best be accomplished upon a basis not only fair but economically sound." Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, Part VIII (1940), p. 1. See also the fuller summary set forth in *Warner Bros. Pictures* v. *Lawton-Byrne-Bruner Insurance Agency Company*, 79 F. 2d 804, 815 (C. A. 8).

vestors are stockholders, petitioner urges (Br. 28 *et seq.*) that the transfer from Chapter XI to Chapter X entails disadvantages for both the debtor and its stockholders. Only Chapter XI, petitioner argues (Br. 28), permits a composition, under which a majority of creditors can bind all to accept a reduction in their claims while leaving intact the stock interests. Hence, it is contended that the stockholders lose an important advantage if the debtor is required to utilize Chapter X (Br. 28). This argument is predicated in part upon the elimination in the 1952 amendments to the Bankruptcy Act of the "fair and equitable" requirement for a Chapter XI arrangement (Br. 18, 31). See pp. 28–37, *supra*.

We observe at the outset, that if trade creditors strongly believe that continuance of the debtor as a going concern will operate to their benefit through the opportunity of making future profits and that this might be impossible unless they accept payment of their claims at a discount, nothing in Chapter X prevents them from voluntarily agreeing to do so in an appropriate case, even though holdouts might insist upon and receive full payment.[21] Moreover, the doctrine

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[21] See, *e.g.*, *In re Keeshin Freight Lines, Inc.*, SEC Corp. Reorg. Release No. 78, at 21 (1949), rejected on other grounds, 86 F. Supp. 439 (N. D. Ill.):

"We see no reason why the eleven business corporations and individuals, including such companies as General Motors Corporation, Socony-Vacuum Oil Co., Inc., and

of absolute priority, required under Chapter X by reason of the "fair and equitable" standard (see fn. 9, *supra*, p. 30), might well be satisfied, in its application to merchandise and bank creditors, on the basis of considerations different from those involving public holders of debt obligations. Compare the *Realty* case, 310 U. S. at 454, where this Court pointed out, at a time when Chapter XI still had the provision that the plan must be "fair and equitable", that "where there are no public or private interests involved requiring protection by the procedure and remedies afforded by Chapter X", there might, under Chapter XI, be a "reduction of the claims of the prior creditors without alteration of the management's interests," if this would be compensated for by "the preservation of going-concern value through their continued management of the business * * *."[22]

Baltimore & Ohio Railroad Company, who hold the parent company's notes, may not accept, voluntarily, parity treatment among themselves. These are not members of the investing public with respect to whom the proposal would be subject to serious criticism upon the grounds of unfairness."

[22] And cf. *In re Muntz TV Inc.*, SEC Corp. Reorg. Release Nos. 95 and 96 (1955), approved, N. D. Ill., E. Div., No. 54B 491, where a plan was found fair to unsecured creditors consisting of "primarily trade creditors, most of whom are continuing to supply merchandise to the debtors, and who, it is expected, will continue this business relationship after the reorganization." SEC Corp. Reorg. Release No. 96 at p. 4. The plan permitted stockholder participation despite

In any event, even assuming that there are advantages for stockholders under Chapter XI which are unavailable under Chapter X, the fact remains that, as held in *Realty*, the debtor may not choose which chapter shall be employed depending upon the type of relief it seeks (pp. 21-23, *supra*). This holding is particularly necessary insofar as the diminution of creditors' rights under Chapter XI is precluded under Chapter X. Congress did not intend that the rights of those having claims against the debtor could vary in accordance with the discretionary choice by management of one chapter or the other.[23]

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the fact that the trade creditors were limited to receiving 75% of their claims in non-interest bearing promissory notes and the balance in voting preferred stock, where, as compensation for the lack of interest on the notes, a creditors committee was given the right in effect to name three of the five members of the Board of Directors until the notes should be paid.

[23] Petitioner also urges (Br. 34) that wage claimants will lose priorities granted by Section 64 of the Bankruptcy Act if it should proceed under Chapter X. In the summary of assets and liabilities contained in the affidavit of the debtor's president, the wage claims to which this argument relates are listed at $440.47 (R. 41a). But even apart from its insignificance in this case, the argument lacks merit. We are aware of no Chapter X case where wage claims for services during the course of the proceedings and for at least several months prior thereto have not received priority and of no instance where this practice has been questioned, except by the wage claimants here. Presumably the courts give recognition to the priority of wage claims on the basis of equitable principles of distribution, such as the "six months rule" applied in equity reor-

Moreover, if the possible advantages of Chapter XI for stockholders were far more substantial than they are, they could not outweigh the plain fact that the same considerations of public policy —the same concern for numerous, frequently unprotected and uninformed public investors—which were decisive in *Realty* are operative whether the investors are "creditors" or "stockholders." Nor is this critical point weakened because, as appears to be true in the instant case, trade creditors may be satisfied with a proposed arrangement under Chapter XI. Even where such creditors are willing to take substantially less than face amount because it is to their interest to have the debtor continue in business, as is possible here, such continuance in business might lead to the dissipation of an existing equity for stockholders, a possibility which, as Judge Clark noted in the opinion below (R. 88), merits careful exploration in the circumstances of this case. Under Chapter X the examination by an independent trustee pursuant to Section 167 would appraise this possibility and give stockholders an opportunity to make an informed choice as to whether or not they should favor any plan continuing the debtor in business. It cannot be expected that manage-

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ganizations. Cf. *Dudley* v. *Mealey*, 147 F. 2d 268 (C. A. 2), certiorari denied, 325 U. S. 873. Of course, wages during the course of the proceeding would be entitled to an express priority under Chapter X as administrative expenses. Section 216 (3) of the Act.

ment, which presumably continues in office so long as operations continue, would be as objective respecting future risks as would an independent trustee.[24]

If continuance of the business should be the ultimate determination, a complete reorganization embracing the debtor's subsidiaries may be required, and is available under Chapter X, insuring that the result of the proceeding would not be merely "to place crutches under [a] corporate cripple * * *" and send it "out into the business

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[24] The House Report on the Chandler Act, in setting forth the abuses to be remedied, quoted the following statement of Mr. Justice (then S. E. C. Chairman) Douglas (H. Rep. No. 1409, 75th Cong., 1st sess., p. 38):

"Management usually remains in dominance of the situation during and after reorganization, as before. It meets only casual scrutiny, at most; its plan is adopted; it does not account. Good, bad, or indifferent management continues in the saddle. It is beyond question that in many cases which are matters of public record, this state of affairs has resulted in hardship and loss. And I believe it equally beyond question that the present method promotes and induces superficial, surface reorganizations which leave uncured dangerous diseases in the corporate body; and that this superficiality of method thwarts the objective of reorganization—the production of a fair and equitable plan and the launching of a vital business enterprise under able, faithful management. * * *"

Cf. Rostow and Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 Yale Law Journal 1334, 1337 (1939):

"* * * Chapter XI offers tremendous advantages of procedure and of result to corporate management, and to the security interests usually held by management."

world to be a menace to all who might purchase * * * [its] securities or deal with * * * [it] on credit."[25] This and other considerations far outweigh petitioner's objection that a Chapter X proceeding entails somewhat greater expense than one under Chapter XI. In the first place, the expense of a single, adequate Chapter X proceeding is obviously worthwhile if it eliminates the cost of a further reorganization which might otherwise be necessary within a few years. Moreover, in a particular case, the independent Chapter X trustee might uncover causes of action on behalf of the stockholders against existing or former management which otherwise might be lost, either because they might never be discovered, the statute of limitations might expire, or they did not survive the Chapter XI proceeding. Such recoveries in many Chapter X proceedings have been substantial,[26] and in a particular case

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[25] Cf. *Price* v. *Spokane Silver & Lead Co.*, 97 F. 2d 237, 247 (C. A. 8), certiorari denied, 305 U. S. 626.

[26] See *Committee* v. *Kent*, 143 F. 2d 684, 687 (C. A. 4), where it was stated:

"* * * Examination under section 167 is one of the important steps in a reorganization where the court is required to exercise an 'informed, independent judgment' based upon 'adequate, trustworthy information' (*National Surety Co.* v. *Coriell*, 289 U. S. 426, 436); and stockholders should not be denied the benefit of a thorough and efficient investigation merely because the assets presently in hand would go to bondholders or debenture holders upon the winding up of the corporation's affairs."

The investigation in that case led to a judgment on behalf of the debtor in excess of $14,000,000, which was ultimately

may more than offset savings resulting from a composition with the creditors. Thorough examinations have also led to subordination of senior claims to stock interests.[27]

Finally, we note petitioner's assertion (Br. 29) that there is a "loss in a proceeding under Chap-

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reversed by reason of the running of the statute of limitations. *Austrian* v. *Williams*, 103 F. Supp. 64 (S. D. N. Y.), reversed, 198 F. 2d 697 (C. A. 2), certiorari denied, 344 U. S. 909. In other cases, however, our experience has shown that substantial amounts have been obtained in reorganizations as a result of prosecutions of actions against former officials. See, *e. g.*, *Gerdes* v. *Reynolds*, 28 N. Y. S. 2d 622 (1941), which arose out of *Reynolds Investing Co., Inc.* (D. N. J. No. 27863); *Heiner* v. *North American Coal Corp.*, W. D. Pa., No. 1756 (1941), *Same*, Common Pleas Court, Philadelphia County, Pa., No. 1854 (1942), *Same*, D. Md., No. 1468 (1942), *Same*, M. D. W. Va., No. 117–W (1942), *Same*, N. D. Ohio (E. D.), No. 21081 (1942), *Same*, Common Pleas Court, Allegheny County, Pa., No. 3311 (1942), all of which arose out of *In re Pittsburgh Terminal Coal Corporation*, W. D. Pa., No. 20716; *Rabinowitz* v. *Nelson*, N. Y. Sup. Ct. (N. Y. Co., No. 30597, 1944) which in turn arose out of *In re Lower Broadway Properties, Inc.*, S. D. N. Y., No. 81840; *Adolf Gobel, Inc.* v. *Skipworth et al.*, 3 N. W. 2d 551 (Sup. Ct., Iowa, 1942) which arose out of *In re Adolf Gobel, Inc.*, S. D. N. Y. No. 79526. *Cf. Ladd* v. *Brickley*, 158 F. 2d 212 (C. A. 1), certiorari denied, 330 U. S. 819, rehearing denied, 330 U. S. 855, which arose out of the reorganization of *International Hydro-Electric System* under Section 11 (d) of the Public Utility Holding Company Act of 1935, see 26 S. E. C. 623 (1947).

[27] *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; and see *Columbia Gas & Electric Corp.* v. *United States*, 151 F. 2d 461 (C. A. 6), certiorari denied, 329 U. S. 737.

ter X of all the experienced management of the debtor." Under Chapter X, however, officers or other members of management can be retained, where deemed desirable, by being employed by the trustee,[28] or if necessary by appointment "as an additional trustee" for the limited purpose of operating the business and managing the property of the debtor.[29] Thus, assuming that the experience of petitioner's present management will be necessary to petitioner's rehabilitation in the new operations on which it has embarked—a matter which may itself warrant exploration under Chapter X, considering the recent history and present circumstances of the corporation as well as the fact that the present management dates only from 1951—this benefit is entirely available in Chapter X proceedings along with the other advantages and protections such proceedings afford.

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[28] Section 191 of the Act.

[29] It is provided in Section 156 of the Act: "In any case where a trustee is appointed the judge may, for the purposes specified in section 189 of this Act, appoint as an additional trustee a person who is a director, officer, or employee of the debtor." Section 189 relates to a trustee's duty to "operate the business and manage the property of the debtor."

CONCLUSION

For the foregoing reasons the judgment of the court below should be affirmed.

Respectfully submitted.

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DECEMBER 1953.

APPENDIX A

Comparison of Provisions of Chapter X and Chapter XI

	Chapter X	Chapter XI
1. Initiation of proceeding.	Debtor, three creditors, or indenture trustee may file petition (Sec. 126).	*Only* debtor may file petition (Secs. 321, 322).
2. Appointment of trustee.	Trustee appointed in every case in which indebtedness is $250,000 or more (Sec. 156).	*No comparable provision.* If trustee in bankruptcy has already been appointed, he must be continued in possession. Otherwise, receiver may be appointed "if necessary" (Secs. 332, 343).
3. Qualifications of trustee.	Must be independent, disinterested (Secs. 156, 158).	*No comparable provision.*
4. Examination of Debtor's financial problems and causes of failure.	Trustee investigates property, liabilities, and financial condition of debtor, the operation of the business, and the desirability of its continuance (Sec. 167 (5); *cf.* Sec. 167 (1)). See also Sec. 21 (a).	Court *may* direct examination by creditor or other party of witnesses concerning acts, conduct, or property of Debtor (Sec. 21a).
5. Report to judge upon past conduct of the Debtor.	Trustee reports to judge facts pertaining to fraud, misconduct, mismanagement and irregularities, and any causes of action available to estate (Sec. 167 (3)).	*No comparable provision.*
6. Reports to security holders.	Trustee submits statement of his investigation to security holders (Sec. 167 (5)).	*No comparable provision.*
7. Formulation of plan.	Trustee gives notice to security holders that they may submit to him suggestions for formulation of plan (Sec. 167 (6)).	*No comparable provision.*
8. Proposal and filing of plan.	Trustee prepares and files plan (or report of reasons why plan cannot be effected) *before* debtor may propose plans or amendments (Sec. 169).	*Only* debtor may propose arrangement (Sec. 323) or modifications (Sec. 363).
9. Assistance of administrative agency.	In cases in which the scheduled indebtedness exceeds $3,000,000, and in other cases if the judge desires, plans which the judge finds worthy of consideration, after hearing, are submitted to the Securities and Exchange Commission for examination and report (Secs. 172, 173). Commission may, with approval of judge, participate in proceeding as a party (Sec. 208).	*No comparable provisions.*
10. Fairness of plan.	Plan may be approved and confirmed only if "fair and equitable, and feasible" (Secs. 124 and 221 (2)).	Plan may be confirmed if in "best interests of the creditors and is feasible" (Sec. 366).
11. Submission of plans for acceptances.	*After* approval by the judge as fair and equitable, and feasible, plans are transmitted to security holders together with informative materials, including the judge's opinion and the Commission's report (Secs. 174, 175).	*No comparable provision*

	Chapter X	Chapter XI
12. Solicitation of acceptances.	May not normally be solicited until *after* judge has approved plan and informative materials have been transmitted (Sec. 176).	May be solicited at any time, even prior to institution of proceeding, and must be obtained *before* court confirms arrangement (Secs 336 (4), 361, 362). No requirement as to data which must accompany solicitation.
13. Acceptances required for confirmation.	Two-thirds in amount of each affected class of creditors and majority of holders of stock (if debtor is not insolvent) (Sec. 179).	Majority in amount and number of each affected class of unsecured creditors (Sec. 362 (1)).
14. Dissenting classes of creditors or stockholders.	If a class of creditors does not accept by two-thirds in amount, or if a class of stockholders does not accept by a majority, the plan may be confirmed if it provides for such classes adequate protection as prescribed by the statute (Secs. 216 (7), (8), 179, 221).	*No comparable provisions.*
15. Classes of security holders which plan may affect.	Plan may alter and modify the rights of any class of creditors, secured or unsecured, and of any class of stockholders (Sec. 216).	Arrangement may provide for settlement, satisfaction, or extension of unsecured debts only (Secs. 306 (1), 357).
16. Participation in proceeding by security holders.	Have right to be heard on all matters arising in proceeding (Sec. 206); and may act in person, by attorney, or by agent or committee (Sec. 209).	*No comparable provision.* A creditors' committee may be selected at or before first meeting of creditors (Sec. 338).
17. Control over representatives of security holders.	Information furnished to court concerning employment and interests of representatives of security holders (such as committees, indenture trustees and attorneys), as well as interests of the persons represented (Secs. 210, 211). The judge is empowered to disregard provisions in authorizations of such representatives or to restrain the exercise of powers which are unfair or contrary to public policy (Sec. 212). Claims or stock acquired by the representatives in contemplation of or during the course of proceeding may be limited to actual consideration paid therefor (Sec. 212).	*No comparable provisions.*
18. Indenture trustees.	Have the right to be heard on all matters arising in the proceeding (Sec. 206); to file a claim on behalf of all holders of securities outstanding under their indenture (Sec. 198); and to file a petition initiating the proceeding under the chapter (Sec. 126).	*No comparable provisions* and no mention of indenture trustees.

	Chapter X	Chapter XI
19. Lists of security holders.	Trustee is under a duty to prepare and file lists of security holders (Sec. 164). Other persons in possession or control of such lists or information relevant thereto may be required to disclose the lists or such information (Sec. 165). Although in a proper case the court may direct impounding of the lists, bona fide security holders and indenture trustees have an unqualified right to use and inspect them upon terms prescribed by the court (Sec. 166).	*No comparable provisions.* Debtor files bankruptcy schedules with petition (Sec. 324).
20. Compensation and allowances	In addition to allowances to officers of the court, the debtor and petitioners, the judge has broad power to make reasonable allowances of compensation and reimbursement for expenses to the representatives of security holders, including committees and indenture trustees, and to individual creditors and stockholders and their attorneys. (Secs. 241-242.)	The debtor is required to deposit the money necessary "to pay the costs and expenses of the proceedings, and the actual and necessary expenses, in such amount as the court may allow," incurred by a creditor's committee (Sec. 337 (2).)
21. Subsidiary corporations.	A petition by or against a subsidiary corporation may be filed in the same court which has approved the petition by or against the parent corporation. (Secs. 129, 106 (33).)	*No comparable provision*, and no mention of subsidiaries.
22. Future management.	Plan must contain provisions which are equitable, compatible with the interests of security holders, and consistent with public policy, with respect to the manner of selection of the reorganized company's directors and officers (Sec. 216 (11)); and identity, qualifications, and affiliations of the persons to be directors and officers must be disclosed and meet same test. (Sec. 221 (5).)	*No comparable provision.*
23. Charter of reorganized company.	Plan must contain provisions requiring inclusion in the reorganized company's charter of provisions for the prohibition of the issuance of nonvoting stock, for the equitable distribution of voting power among the new securities possessing such power, for the election of directors representing preferred stockholders in the event of default in payment of preferred dividends, for the general fair and equitable treatment of securities, and for periodic corporate reports to security holders. (Secs. 216 (12).)	*No comparable provision.*

APPENDIX B

UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

No. 91173

IN THE MATTER OF LIBERTY BAKING CORPORATION, DEBTOR

MEMORANDUM

Filed: U. S. District Court, S. D. of N. Y., Dec. 19, 1955

NOONAN, *D. J.*

The Securities and Exchange Commission has moved herein for leave to intervene and to (1) dismiss the Debtor's petition, (2) refuse confirmation of the Debtor's arrangement, and (3) to dismiss the proceeding unless the petition be amended, or a creditors' petition be filed, conforming to the provisions of Chapter X of the Bankruptcy Act.

In brief, this is another case wherein the Securities and Exchange Commission feels that there is a sufficient public interest to warrant the court setting aside all that has gone before, in the proceedings already had pursuant to Chapter XI of the Bankruptcy Act.

The growing problem that this type of case raises for parties, the bar and the bench, is referred to in the October 1955 issue of the Journal of the National Association of Referees in Bankruptcy, Vol. 29, p. 139.

The Transvision case (*in re Transvision, Inc.*, 119 F. Supp. 134, aff'd 217 F. 2d 243; cert. den'd 348 U. S. 952) is authority for the proposition that public ownership of a substantial portion of the stock is not, per se, proof of sufficient public interest to call for all of the safeguards of a Chapter X proceeding. The latter procedure is designed to protect unsecured creditors in general rather than stockholders alone.

Inevitably, by virtue of the wording of the Act itself, the determination of each case must rest on its own merits and on its own special state of facts with regard to the debtor's financial and debt structure.

In the instant case, the debtor has the following securities outstanding:

(1) 4% debentures due in 1978—$1,602,420 (of which 35% in value is in the hands of management, former and present);

(2) 791 shares of $4 preferred stock, all in the hands of 27 members of the public;

(3) 43,064 7/20 shares of no par common stock, of which 79% is held by management.

The debtor is a holding company and its sole asset is the entire capital stock of Bell Bakeries, Inc., which owns and operates bakeries in six states. Since Liberty is not in any separate business, its liabilities are generally limited to its debentures.

The latest annual consolidated balance sheet for the debtor and its wholly-owned subsidiary (dated January 1, 1955) lists the total assets at $3,237,731 and the total liabilities at $3,961,416, indicating a net capital deficiency of $723,685.

Although the debtor, through its subsidiary, has shown substantial losses over the past few years, its latest balance sheet shows a gain.

The subsidiary corporation filed a petition under Section 322 of the Bankruptcy Act and an arrangement was proposed and confirmed by the Court whereby unsecured creditors are to be paid 65% in quarterly installments over a 4½ year period. In the Bell Baking Co. proceeding, trade creditors filed claims in the amount of $685,672, thus obligating the subsidiary (whose stock is the sole asset of the current debtor) to pay out almost $450,000 in regular installments over 4½ years.

The proposed arrangement herein contemplates a merger of the two corporations, and the issuance of $1 par preferred stock to holders of the debtor's outstanding debentures in the sum of $1,602,420 (at the rate of one share for each sixty dollars of debenture), which stock is to pay dividends of $2.50 a share, but remain limited to $50 per share in liquidation by lot, and to be temporarily non-cumulative so as to permit the subsidiary company's obligations to be met.

According to the facts and figures of this case, there are only 333 public holders, holding approximately 27,000 securities of all types; of this group only 198 are debenture holders.

The proposed arrangement provides that, after conversion of the debentures to preferred stock, the new preferred stockholders will elect 3 of the 7 directors. It further provides that, in the event of certain defaults in payment, these new preferred stockholders may elect the entire Board

of Directors. The debentures came into being by a previous conversion from preferred stock; the arrangement under consideration would reconvert the debentures back into preferred stock. The debtor's financial structure is and will be relatively simple.

In view of all of the above, it does not seem that the proposed arrangement affects a substantial public interest.

In the *Transvision case* (supra), Judge Medina stated, at page 246:

> "Indeed, the Bankruptcy Act itself, in requiring every petition under Chapter X to state 'Why adequate relief cannot be obtained under Chapter XI' Bankruptcy Act, Sec. 130 (7), 11 U. S. C. A. Sec. 530 (7), and in declaring that 'A (Chapter X) petition shall be deemed not to be filed in good faith if * * * (2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter II of this title', Bankruptcy Act Sec. 146, 11 U. S. C. A. Sec. 546, manifests a conscious purpose of Congress to encourage resort to Chapter XI whenever the remedy afforded thereby adequately protects the interests involved."

It is the opinion of this court that the remedy afforded by the arrangement as worked out between management and the creditors' committee adequately protects the interests involved, and that to require the parties to go through a Chapter X proceeding would be needless and time-consuming, as well as the cause of further expense to all parties.

It is, therefore, the ruling of this court that the petition of the Securities and Exchange Commission for leave to intervene, and for certain other relief referred to in the beginning of this opinion, should be, and hereby is, denied.

So ordered.

Dated: New York, N. Y., December 19, 1955.

GREGORY F. NOONAN,
U. S. D. J.